Federal Housing Finance Agency
Office of Inspector General

FHFA's Oversight of the Enterprises' Lender-Placed Insurance Costs

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At A Glance

June 25, 2014

FHFA's Oversight of the Enterprises' Lender-Placed Insurance Costs

Why OIG Did This Report

Fannie Mae and Freddie Mac (collectively, the Enterprises) require their borrowers to maintain hazard insurance on their homes. The insurance safeguards the value of the homes in the event of a fire or other covered incident, thereby preserving the Enterprises' interests in them.

The Enterprises' mortgage servicers are responsible for ensuring that borrowers maintain hazard insurance on their properties. To do so, the servicers outsource this task to specialty insurance companies that track the status of borrowers' insurance policies. When a provider identifies a lapse in hazard insurance, it initiates new coverage known as lender-placed insurance (LPI).

Borrowers are responsible for paying LPI premiums but do not always do so. Upon foreclosure, the cost of a borrower's unpaid LPI premiums shifts to the Enterprise that owns or guarantees the mortgage. In 2012, the Enterprises paid approximately $360 million in LPI premiums.

In 2012 and 2013, several state insurance regulators determined that LPI rates in their respective jurisdictions were excessive. The same regulators also found that LPI rates may have been driven up by profit-sharing arrangements under which servicers were paid to steer business to LPI providers. Such arrangements often took the form of commission structures and reinsurance deals.

We conducted this evaluation to assess the financial impact of LPI on the Enterprises and determine whether the Federal Housing Finance Agency (FHFA or Agency), in its role as the Enterprises' conservator, has taken sufficient measures to conserve the Enterprises' assets in this regard.

OIG Analysis and Finding

FHFA Has Acted to Restrict Certain Potentially Collusive Practices Employed by the Enterprises' Servicers and LPI Providers

In November 2013, FHFA sought to mitigate financial harm to the Enterprises by directing them to prohibit their servicers from receiving LPI-related commissions and entering into reinsurance arrangements with LPI providers. Subsequently, both Enterprises issued new, conforming servicing guidelines that became effective on June 1, 2014.

At A Glance

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FHFA Has Not Assessed Whether the Enterprises Should Pursue Litigation against Servicers and LPI Providers to Recover Potential Damages

FHFA has yet to complete a thorough assessment regarding the merits of potential litigation on behalf of the Enterprises to recover financial damages associated with past abuses in the LPI market. Agency officials cited competing priorities, such as finalizing other financial settlements, as the reason for not completing such an assessment.

Our analysis suggests that the Enterprises have suffered considerable financial harm in the LPI market. For example, using a methodology similar to that utilized by a state insurance regulator, we estimate that—in 2012 alone—the Enterprises' combined financial harm amounted to $158 million due to excessively priced LPI coverage.

What OIG Recommends

We recommend that FHFA assess the merits of litigation by the Enterprises against their servicers and LPI providers to remedy potential damages caused by past abuses in the LPI market and, then, take appropriate action in this regard.

FHFA accepted this recommendation (see Appendix A). As noted in its formal response, the Agency will complete its litigation assessment within 12 months.

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ABBREVIATIONS

Assurant	Assurant, Inc.
Enterprises	Fannie Mae and Freddie Mac
Fannie Mae	Federal National Mortgage Association
FHFA or Agency	Federal Housing Finance Agency
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
Freddie Mac	Federal Home Loan Mortgage Corporation
LPI	Lender-Placed Insurance
NAIC	National Association of Insurance Commissioners
NYDFS	New York Department of Financial Services
OIG	Federal Housing Finance Agency Office of Inspector General
QBE	QBE Holdings, Inc.

PREFACE

FHFA has been the conservator of the Enterprises since September 2008.[1] Pursuant to federal law, FHFA may act as necessary to maintain the Enterprises in a solvent condition. It is also statutorily charged with conserving and preserving their assets, which are substantial; together, the Enterprises own or guarantee about $4.8 trillion in mortgages.[2]

The Enterprises' servicers are required to ensure that borrowers maintain hazard insurance on their homes to protect the Enterprises' financial interests. If a borrower fails to maintain adequate hazard insurance, then it becomes the servicer's obligation to obtain such coverage.

The cost of a new policy, which is referred to as lender-placed insurance (LPI),[3] is initially billed to the borrower.[4] Upon foreclosure, however, the cost of a borrower's unpaid LPI premiums is shifted to the Enterprise that owns or guarantees the mortgage. In 2012, the Enterprises paid approximately $360 million in such LPI premiums.

We conducted this evaluation to determine the financial impact of the LPI market upon the Enterprises. We also sought to determine whether FHFA, in its role as the Enterprises' conservator, should undertake additional LPI-related actions.

This evaluation was led by Brian Harris, Investigative Counsel, assisted by Angela Choy, Director of Operations and Program Oversight, and Bruce McWilliams, Senior Investigative Evaluator. The report has been distributed to Congress, the Office of Management and Budget, and others, and it will be posted on OIG's website, www.fhfaoig.gov.

Richard Parker
Deputy Inspector General for Evaluations

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[1] On September 6, 2008, FHFA placed the Enterprises into conservatorships as authorized by the Housing and Economic Recovery Act of 2008. *See* Pub. L. 110-289, § 1145, 122 Stat. 2734-35 (2008).

[2] Fannie Mae, *2013 Form 10-K*, at 175 (Feb. 21, 2014); Freddie Mac, *2013 Form 10-K*, at 94 (Feb. 27, 2014).

[3] Lender-placed insurance is also known as, and synonymous with, force-placed insurance.

[4] The servicer may bill the borrower for the entire amount or seek reimbursement according to an amortization schedule.

CONTEXT

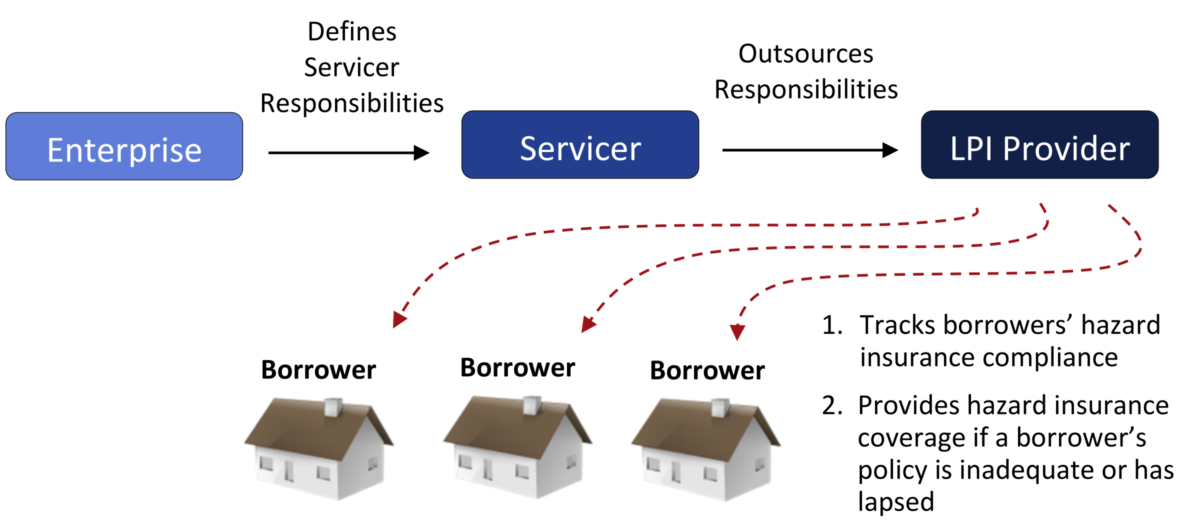
The Enterprise that Holds the Mortgage Is Liable for a Borrower's Unpaid LPI Premiums after Foreclosure

The Enterprises contract with servicers to ensure the homes that secure their mortgages are covered continuously by hazard insurance.[5] Generally, servicers outsource this task to specialty insurance companies—LPI providers. As depicted in Figure 1 below, the LPI providers:

- Track hazard insurance coverage on the mortgaged properties; and
- Place hazard insurance on properties whose coverage has become deficient.

Two LPI providers and their subsidiaries do most of this work for the Enterprises' servicers. The companies are Assurant, Inc. (Assurant) and QBE Holdings, Inc. (QBE).[6] Collectively, Assurant and QBE subsidiaries write more than 90% of the nation's LPI coverage, according to industry observers.

FIGURE 1. ENTERPRISE, SERVICER, AND LPI PROVIDER RELATIONSHIP



[5] These obligations are outlined in the Enterprises' servicing guides. Fannie Mae, *Fannie Mae Single Family 2012 Servicing Guide*, at Part II, Chapter 2, § 201 (Mar. 14, 2012) (online at www.fanniemae.com/content/guide/svc031412.pdf); Freddie Mac, *Single-Family Seller/Servicer Guide*, at Volume 2, Chapter 58, § 12 (Dec. 18, 2013) (online at www.freddiemac.com/singlefamily/guide/bulletins/pdf/2013Guide.pdf).

[6] Both Assurant and QBE are holding companies that own subsidiary insurance companies. These subsidiaries are the LPI providers that write the LPI coverage discussed in this evaluation report.

Under this arrangement, the Enterprises' servicers are responsible for negotiating and purchasing insurance from LPI providers;[7] however, the borrowers and Enterprises are ultimately liable for the premiums.[8] For example, when an LPI provider determines that a mortgaged home is not covered adequately by hazard insurance, it places coverage on it and bills the Enterprise's servicer.[9] The servicer then advances the premium to the LPI provider and charges the borrower for that expense.[10] In the event of foreclosure, the Enterprise that holds the mortgage reimburses the servicer for the borrower's unpaid LPI premiums. According to the Enterprises, they reimbursed servicers approximately $360 million for LPI premiums in 2012 and $327 million in 2013.[11]

Several State Insurance Regulators Have Found LPI Premium Rates to Be Excessive

Over the last two years, insurance regulators in three large states—New York, Florida, and California[12]—determined that Assurant, QBE, and their subsidiaries charged excessive rates for LPI.[13] The state regulators also found that, in certain cases, LPI rates may have been driven up, in part, by profit-sharing arrangements entered into by the servicers and the LPI providers. The regulators have employed a variety of enforcement techniques to reduce LPI rates within their respective jurisdictions and prevent further abuses. The details of the state insurance regulators' enforcement actions are set forth below.

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[7] LPI is often sold as a group insurance master policy. Essentially, the policy covers a predetermined group of mortgaged homes rather than just a single home. LPI coverage is usually priced as a fixed dollar amount per $100 of coverage.

[8] On average, LPI premiums are approximately 1.9 to 2.3 times more expensive than a borrower's voluntary hazard insurance premiums. LPI providers have advanced a variety of reasons for this phenomenon, including the fact that they incur the risks associated with insuring most residences sight unseen. Other industry observers note that this risk is offset by other factors and, therefore, it should not drive up the price of LPI. The offsets include the fact that LPI is generally less comprehensive than regular hazard insurance. For example, it usually does not cover personal property within the residence. Moreover, LPI has less overhead connected with it. As the LPI providers note, most policies are not produced through individual underwriting.

[9] Technically, the LPI provider issues a certificate of coverage under the group insurance master policy.

[10] After it is placed, an LPI policy remains in effect until the borrower acquires adequate hazard insurance on the mortgaged home or the home is foreclosed upon.

[11] The Enterprises reimbursed their servicers approximately $587 million from 2009 to 2011.

[12] Significantly, 48% of earned LPI premiums nationwide were attributed to homes in New York, Florida, and California in 2012.

[13] State insurance regulators exercise jurisdiction over insurance companies operating in their respective states. They promulgate regulations and bring enforcement actions to protect consumers against abusive insurance practices. State insurance regulators also protect consumers whose mortgages are owned or guaranteed by the Enterprises and other creditors, such as commercial banks.

The state regulators' factual findings regarding LPI providers, discussed herein, were primarily issued to protect individual borrowers, and not the Enterprises. Nevertheless, these findings may be informative because the Enterprises, like the borrowers, consume LPI. That is, they assume liability for individual borrowers' unpaid LPI premiums upon foreclosure.

New York. In spring 2013, the New York Department of Financial Services (NYDFS) found that subsidiaries of Assurant and QBE violated New York's insurance laws by charging excessive LPI rates.[14] NYDFS came to this conclusion by examining the subsidiaries' **loss ratios**. It found that the LPI providers' actual loss ratios were particularly low in comparison with the expected loss ratios they filed with the state.[15] The regulator concluded that the disparity between LPI providers' actual and expected loss ratios indicated that the LPI providers were retaining a relatively large amount of insurance premiums (see Figure 3 below).

Loss ratio is the percentage of collected premiums that an insurer returns to its policy holders as insurance claims (see Figure 2). A high loss ratio indicates that the insurer has *returned* to its insured, through the payment of claims, a large portion of the premiums it has collected. Conversely, a low loss ratio indicates that the insurer has *retained* a large portion of the premiums it has collected.

For example, a loss ratio of 60% signifies that that, on average, an insurer returned $60 to its insured for every $100 it collected in premiums. The insurer retains the remaining 40%, or $40 in this example, to cover administrative costs, taxes, and profits.

FIGURE 2. LOSS RATIO EQUATION[16]

$$\textbf{LPI Provider's Loss Ratio} = \frac{\textbf{Claims Paid}}{\textbf{Premiums Collected}}$$

[14] The Insurance Division within NYDFS "supervises all insurance companies that do business in New York. The Insurance Division oversees nearly 1,700 insurance companies with assets exceeding $4.2 trillion." NYDFS website. Accessed Apr. 8, 2014, at www.dfs.ny.gov/about/dfs_about.htm.

[15] Approximately half of the states' insurance regulators require the insurance providers operating within their jurisdictions to file rates and obtain approval for them. Expected loss ratios are typically a part of these filings.

[16] The loss ratios in this evaluation report generally account for any changes in claim and premium reserves in a reported period.

FIGURE 3. LOSS RATIO DATA FOR SUBSIDIARIES OF ASSURANT AND QBE IN THE STATE OF NEW YORK

Assurant Subsidiary[17]

Year	Loss Ratio	Expected Loss Ratio on File
2006	24.7%	58.1%
2007	19.4%	58.1%
2008	17.3%	58.1%
2009	22.8%	58.1%
2010	24.3%	58.1%
2011	24.7%	58.1%
2012	42.8%	58.1%

QBE Subsidiary[18]

Year	Loss Ratio	Expected Loss Ratio on File
2006	20.7%	55.0%
2007	18.6%	55.0%
2008	29.0%	55.0%
2009	18.2%	55.0%
2010	18.5%	55.0%
2011	13.5%	55.0%
2012	45.3%	55.0%

Source: NYDFS Consent Order with Assurant, at 5 (Mar. 21, 2013) (online at www.dfs.ny.gov/about/press2013/assur-order-130321.pdf); NYDFS Consent Order with QBE, at 6-7 (Apr. 18, 2014) (online at www.dfs.ny.gov/about/ea/ea_201304181_qbe.pdf).

Notably, the Assurant subsidiary's loss ratio was below 25% in six of the seven years reported. The LPI provider's expected loss ratio on file during that time was approximately 58%. NYDFS observed that the LPI provider's loss ratio elevated to just 42.8% in 2012—a year in which the state was hit by a severe storm. Similarly, the QBE subsidiary's loss ratio was below 30% in six of the seven years reported while its expected loss ratio was 55%.[19]

Additionally, NYDFS found that the LPI providers employed several mechanisms through which they shared their profits with the servicers who steered business to them. First, the LPI providers paid commissions to the servicers' insurance agency affiliates, which ranged from 10% to 20% of the LPI premiums purchased. NYDFS found that these servicer affiliates "do little or no work for the commissions."[20] Second, NYDFS found that the Assurant subsidiary shared its profits with servicers using reinsurance arrangements.[21] Under these arrangements, the LPI provider shared a set percentage of its earned premiums and claims paid—known as a quota share basis—with affiliates of the servicer. NYDFS concluded that both commissions and reinsurance arrangements tend to incent servicers to purchase higher priced LPI.

[17] American Security Insurance Company.

[18] The table reflects Empire Fire and Marine Insurance Company data from 2006 to 2008. In December 2008, QBE acquired ZC Sterling Corporation and assumed Empire Fire and Marine Insurance Company's New York LPI market share. The data from 2009 to 2012 reflect QBE Insurance Corporation's loss ratios.

[19] Low loss ratios were not unique to New York during this period. From 2004 to 2012, respectively, the nationwide LPI average loss ratios were: 33.1%, 53.5%, 29.0%, 20.5%, 23.3%, 20.7%, 17.3%, 24.7%, and 30.8%. The LPI average loss ratio for all nine years was 25.3%.

[20] NYDFS Consent Order with Assurant, at 5; NYDFS Consent Order with QBE, at 7.

[21] Reinsurance allows an insurance provider to share a portion of its risk with another entity.

Ultimately, the two LPI providers entered into consent orders under which they were required to pay $24 million in civil penalties and provide restitution to affected borrowers.[22] They were also required to refrain from remitting commissions to servicers or entering into reinsurance arrangements with them. Finally they were required to set new LPI rates that would support an expected loss ratio of 62% or greater.

Florida. In August 2012, the Florida Office of Insurance Regulation[23] found that a QBE subsidiary's LPI rates were excessive and did not comply with Florida law.[24] Six months later, the LPI provider agreed to reduce its rates by 18.8%.[25] Furthermore, in October 2013, the Florida Office of Insurance Regulation entered into a consent order with the Assurant subsidiary that then had the largest LPI market share in Florida.[26] Under the order, the LPI provider was required to reduce its rates by 10%. Moreover, both LPI providers were required to cease paying commissions to servicers or entering into reinsurance agreements with them.

California. In March 2012, the California Department of Insurance observed low loss ratios during a review of LPI providers' rate filings;[27] it later determined that the LPI rates were excessive. The insurance commissioner directed the largest LPI providers in the state to resubmit their filings at lower rates. Subsequently, an Assurant subsidiary reduced its rates by 30.5%[28] and a QBE subsidiary reduced its rates in the state by 35%.[29]

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[22] NYDFS' investigations resulted in consent orders with Assurant, QBE, Balboa Insurance Company, and American Modern Home Insurance Company. This evaluation report focuses upon the findings in the Assurant and QBE consent orders because those two LPI providers write at least 90% of LPI nationwide.

[23] The Florida Office of Insurance Regulation ensures "that insurance companies licensed to do business in Florida are financially viable; operating within the laws and regulations governing the insurance industry; and offering insurance policy products at fair and adequate rates which do not unfairly discriminate against the buying public." Florida Office of Insurance Regulation website. Accessed Apr. 8, 2014, at www.floir.com/Office/MissionStatement.aspx.

[24] Florida Office of Insurance Regulation, Notice of Intent to Disapprove (Aug. 10, 2012) (online at www.floir.com/siteDocuments/PraetorianNOI12-07860.pdf).

[25] Florida Office of Insurance Regulation, Press Release (Feb. 11, 2013) (online at www.floir.com/pressreleases/viewmediarelease.aspx?id=2000).

[26] Florida Office of Insurance Regulation Consent Order with American Security Insurance Company (Oct. 7, 2013) (online at www.floir.com/siteDocuments/AmericanSecurity141841-13-CO.pdf).

[27] The California Department of Insurance ensures "vibrant markets where insurers keep their promises and the health and economic security of individuals, families, and businesses are protected." California Department of Insurance website. Accessed Apr. 8, 2014, at www.insurance.ca.gov/0500-about-us/.

[28] California Department of Insurance, Press Release (Oct. 22, 2012) (online at www.insurance.ca.gov/0400-news/0100-press-releases/2012/release149-12.cfm).

[29] California Department of Insurance, Press Release (Jan. 31, 2013) (online at www.insurance.ca.gov/0400-news/0100-press-releases/2013/release010-13.cfm).

Some Mortgage Borrowers Have Recovered a Portion of Their LPI Premiums after Initiating Litigation against Servicers and LPI Providers

As early as 2011, some mortgage borrowers began filing class action lawsuits against their servicers[30] and LPI providers.[31] The borrowers sought, among other things, damages stemming from a variety of LPI-related charges. Specifically, the borrowers alleged that their servicers:

- Breached their contract with the borrowers by charging LPI rates that included unearned commissions and lucrative reinsurance premiums;
- Violated the covenant of good faith and fair dealing that is implied in every contract when they manipulated the LPI marketplace to benefit themselves;[32]
- Colluded with LPI providers to artificially inflate premiums, thereby unjustly enriching the servicers and the LPI providers at the expense of the borrowers; and
- Breached the fiduciary duty they owed the borrowers by charging unnecessary premiums.

Several of these lawsuits have settled[33] out of court for substantial sums of money—a total of at least $674 million to date. For example, Wells Fargo and QBE settled with a class of Florida borrowers for $19 million in May 2013.[34] They agreed to reimburse or credit affected borrowers 25% of any LPI premium they assessed. In September 2013, JPMorgan Chase and Assurant settled with a nationwide class of borrowers for $300 million.[35] The defendants agreed to reimburse or credit affected borrowers 12.5% of any LPI premium they assessed. Finally, in February 2014, Citibank and a class of borrowers agreed to a $95 million

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[30] We use the words "servicers" and "lenders" synonymously in our discussion of these lawsuits because, in all of them, the borrower's lender and the servicer were closely affiliated with each other.

[31] Many of these borrowers' mortgages may have been owned or guaranteed by the Enterprises. *See Finding* section below for a discussion of the lawsuits' potential applicability to the Enterprises.

[32] Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement. Restatement (Second) of Contracts § 205 (1981).

[33] Because these lawsuits have resulted in settlements, there have been no judicial findings of fact concerning the borrowers' allegations listed above.

[34] *See Williams v. Wells Fargo Bank, N.A*, No. 1:11-cv-21233 (S.D. Fla. 2013).

[35] *See Herrick v. JPMorgan Chase Bank, N.A.*, No. 1:13-cv-21107 (S.D. Fla. 2014).

settlement[36] in which Citibank would also refund 12.5% of the LPI premiums it billed to borrowers.[37,38]

FHFA Has Acted to Restrict Certain Potentially Collusive Practices Employed by Servicers and LPI Providers

FHFA has used its conservatorship authority to restrict certain profit-sharing practices between the servicers and LPI providers in an effort to mitigate financial harm to the Enterprises. In March 2013, FHFA published a notice in the Federal Register requesting public input on proposals to prohibit certain commissions and reinsurance arrangements.[39] Then, in April 2013, FHFA established a regulatory working group to ensure that federal and state regulators, as well as industry stakeholders, were actively engaged in the reform process.[40]

That summer, before finalizing the LPI proposals, FHFA considered the views of the regulatory working group and reviewed more than 30 replies to its notice in the Federal Register. In November 2013, FHFA directed the Enterprises to restrict servicer commissions and reinsurance arrangements. In December 2013, the Enterprises released updated servicing guidelines that included the new restrictions. They became effective on June 1, 2014.

Generally, the new guidelines prohibit servicers and their affiliates from receiving any form of commission or incentive-based compensation from LPI providers. They also explicitly restrict any type of reinsurance arrangement between a servicer's affiliate and an LPI provider. Finally, they give the Enterprises the right to inspect any contractual documents between servicers and LPI providers to ensure compliance.

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[36] *See Coonan v. Citibank, N.A.*, No: 1:13-cv-00353 (N.D.N.Y filed Mar. 27, 2013) (consolidated with *Casey v. Citibank, N.A.*, No. 5:12-cv-00820 (N.D.N.Y. filed May 17, 2012)).

[37] Citibank also agreed to refund borrowers 8%—or about $15 million total—of any paid or charged lender-placed flood or stand-alone wind insurance premiums.

[38] Since February 2014, several other borrower class action lawsuits are moving toward settlement. In LPI litigation against Bank of America and QBE, borrowers have agreed to a settlement of $228 million. *See Hall v. Bank of America, N.A.*, No. 1:12-cv-22700 (S.D. Fla. filed July 24, 2012). In LPI litigation against HSBC and Assurant, borrowers have agreed to a settlement valued at $32 million. *See Lopez v. HSBC Bank USA, N.A.*, No. 1:13-cv-21104 (S.D. Fla. filed Mar. 28, 2013).

[39] 78 Fed. Reg. 19263 (Mar. 29, 2013).

[40] The working group is comprised of seven federal regulators and fourteen state regulators.

FINDING ....

FHFA Has Not Assessed Whether the Enterprises Should Pursue Litigation against Servicers and LPI Providers to Recover Damages

FHFA is statutorily obligated to preserve and conserve the Enterprises' assets while they are in conservatorship. As set forth above, the Agency has taken some steps to prevent the Enterprises from being harmed further by their servicers and LPI providers. However, it has not determined whether the Enterprises should pursue litigation to recover damages caused by their servicers' and the LPI providers' past practices. Our analysis indicates that such litigation could result in financial recoveries for the Enterprises.

FHFA Has Not Assessed the Potential for LPI-Related Financial Recoveries

During this evaluation, we asked FHFA's Office of General Counsel if it had conducted an assessment to determine whether the Enterprises should pursue LPI-related litigation against their servicers or LPI providers. An official from that office said that it had not yet done so, citing competing priorities, such as finalizing pending legal claims. The official said, however, that FHFA's Office of General Counsel would consider undertaking such an assessment.

Recent State Regulatory Findings and Borrower Class Action Settlements May Inform FHFA's Assessment of LPI-Related Litigation

We believe that the Enterprises may be able to benefit from LPI-related litigation. As noted above, several state insurance regulators have documented abusive practices by some servicers and LPI providers. Consequently, these state regulators required LPI providers to substantially lower their premiums. Further, in some cases, regulators and LPI providers have mutually agreed to provide restitution to affected borrowers, implying that the borrowers were financially harmed by potentially collusive industry practices. As large consumers of LPI, the Enterprises have likely sustained similar financial harm as a result of these practices.[41]

Additionally, there are key similarities between the Enterprises and the borrowers who have recently settled class action lawsuits with servicers and LPI providers. Specifically:

[41] FHFA has explicitly acknowledged that certain servicer and LPI provider practices may have resulted in potential losses to the Enterprises.

- The Enterprises reimbursed their servicers for the cost of borrowers' unpaid LPI premiums after foreclosure;
- The Enterprises' servicers include some of the same servicers that were defendants in the borrowers' class action lawsuits; and
- The Enterprises' servicers purchased LPI coverage from the same LPI providers that were defendants in the borrower class action lawsuits.

Accordingly, the Enterprises may have been harmed in the same manner as the borrowers who settled the class action lawsuits described above. That is, the Enterprises' servicers may have breached their contractual obligations to the Enterprises if they charged them for excessively priced LPI coverage and then shared in the resulting profits. Therefore, like the borrowers, the Enterprises may be able to secure similar financial recoveries.[42,43]

We acknowledge that the servicers and LPI providers would raise defenses to any such claims asserted by the Enterprises. For example, the servicers might claim that they never expressly breached a contract. Rather, they may argue that the LPI coverage at issue was purchased in compliance with the Enterprises' servicing guidelines and, thus, there is no claim.[44]

This is similar to a defense that the servicers advanced in the borrower class action lawsuits. There, the servicers sought dismissals claiming that, notwithstanding the higher cost of LPI, they were contractually required to purchase it.[45] Moreover, they noted that the borrowers' mortgage contracts themselves expressly stated that the cost of LPI could "significantly exceed" the cost of the borrower's previous policy.[46] However, the servicers' motions to dismiss were denied by the courts that ruled upon them.[47]

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[42] One of the Enterprises has recognized the legitimacy of this line of reasoning.

[43] The Enterprises may also consider causes of action sounding in breach of the implied covenant of good faith and fair dealing, breach of fiduciary duty, and unjust enrichment. Additionally, given that the Enterprises are currently in federal conservatorship, the Department of Justice may be able to utilize causes of action that have their basis in statutes reserved to the United States. This may include, for example, claims brought under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. § 1833a (2012), or the False Claims Act, 31 U.S.C. §§ 3729–3733 (2012).

[44] Both Enterprises' servicing guides require their servicers to procure LPI if the borrower fails to maintain adequate hazard insurance. Fannie Mae's servicing guide acknowledges that LPI coverage may cost more than voluntary homeowner's insurance. *Fannie Mae Single Family 2012 Servicing Guide*, at 206-1.

[45] HSBC argued that the borrower's mortgage contract did not prohibit the servicer from earning profits in procuring LPI, and that HSBC complied with the terms of the contract. *See* HSBC's Motion to Dismiss at 11, *Lopez v. HSBC*, ECF No. 11; *see also* JPMorgan Chase's Motion to Dismiss at 7, *Herrick v. JPMorgan Chase*, ECF No. 35.

[46] *See, e.g.*, Bank of America's Motion to Dismiss at 3, *Hall v. Bank of America*, ECF No. 192.

[47] In the Wells Fargo, Citibank, and Bank of America litigation, the courts denied the servicers' motions to dismiss—which argued there was no basis for the borrowers' breach of contract claims—at least once prior to settlement.

Regardless, we do not believe potential defenses should deter FHFA from *assessing* whether the Enterprises should pursue LPI-related litigation against their servicers or LPI providers.

The Enterprises May Be Able to Secure Financial Recoveries through LPI-Related Litigation against Some Servicers and LPI Providers

In deciding whether to pursue LPI-related litigation, FHFA should balance the expected cost of such litigation against the expected recovery.[48] Our analysis suggests that the Enterprises likely suffered significant financial harm due to excessive LPI rates in recent years and, therefore, the potential recovery from LPI-related litigation may outweigh its costs.

We estimate that, in 2012 alone, the Enterprises suffered $158 million in financial harm as a result of reimbursing their servicers for excessively priced LPI coverage. This estimate is based on a methodology similar to that utilized by NYDFS in its recent enforcement actions against subsidiaries of Assurant and QBE. As depicted in Figure 4, below, the $158 million is the difference between the amount that the Enterprises *actually* paid in premiums—$360 million—and a *reasonable* price for such coverage—$202 million. In other words, our retrospective analysis suggests that in 2012 the Enterprises paid LPI premiums that were priced nearly 79% greater than was reasonable for the LPI providers to charge in order to cover their claims.

FIGURE 4. ESTIMATE OF ENTERPRISES' FINANCIAL HARM DUE TO EXCESSIVE LPI RATES IN 2012

Enterprise Reimbursements for LPI Premiums	Estimate of Reasonable Price for Equivalent LPI Coverage	Estimate of Financial Harm
$360 million	$202 million	$158 million

Note: See the *Objectives, Scope, and Methodology* section of this report for a description of the methodology by which we arrived at this estimate and its limitations.

This calculation serves to demonstrate how severely the Enterprises were harmed by their payment of excessively priced LPI premiums; and how important it is that FHFA evaluate the merits of litigation intended to recover damages from certain servicers and LPI providers.[49]

[48] LPI-related litigation costs would include attorney fees and other litigation-related expenses. Further, there could be certain indirect costs, such as the negative impact litigation may have on the Enterprises' relationships with the servicers whom they employ to manage borrower accounts. The potential recovery would include proceeds that result from a judgment or settlement.

[49] We do not necessarily expect FHFA and the Enterprises to pursue or recover damages in this amount—actual damages may be higher or lower. For example, the amount could be higher if they pursue recoveries for multiple years rather than just 2012. Conversely, it could be lower if they employ a different methodology.

CONCLUSIONS

We conclude that FHFA has taken some steps to prevent the Enterprises' servicers and LPI providers from inflicting further financial harm upon them. However, FHFA has not yet completed its assessment regarding the merits of litigation by the Enterprises against their servicers and LPI providers to remedy damages caused by past abuses in the LPI market. We believe that FHFA—as the Enterprises' conservator—has a responsibility to conduct such an assessment because the failure to do so could result in potentially forgoing significant financial recoveries.

RECOMMENDATION

We recommend that FHFA assess the merits of litigation by the Enterprises against their servicers and LPI providers to remedy potential damages caused by past abuses in the LPI market and, then, take appropriate action in this regard.

FHFA accepted this recommendation (see Appendix A). As noted in its formal response, the Agency will complete its litigation assessment within 12 months.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objectives of this evaluation were to: (1) assess the financial impact of the LPI market upon the Enterprises; and (2) determine whether FHFA, in its role as the Enterprises' conservator, should undertake additional LPI-related actions.

To address these objectives generally, we interviewed FHFA officials in the Division of Housing Mission and Goals, the Division of Enterprise Regulation, and the Office of General Counsel. We also interviewed officials at both Enterprises responsible for their business dealings with servicers and LPI providers. Additionally, we reviewed Enterprise LPI-related financial data, such as annual premiums paid, and reviewed numerous FHFA and Enterprise documents that contain LPI analyses. Finally, we reviewed testimony from industry experts and various other topical, publicly available documents.

Methodology for our Estimate of the Harm that the Enterprises Suffered Due to Excessive LPI Premium Rates in 2012

We estimated the harm the Enterprises suffered due to excessive LPI rates by utilizing a methodology similar to that employed by the NYDFS in recent enforcement actions against subsidiaries of Assurant and QBE. Specifically, using 2012 data, we calculated the difference between (1) the *actual* amount the Enterprises reimbursed the servicers for LPI coverage, and (2) an estimate of the *reasonable* price for the coverage. We acknowledge limitations in our methodology, and they are disclosed at the end of this section.

We took the following steps to develop our estimate of the financial harm suffered by the Enterprises:

Step 1: Determine the amount the Enterprises reimbursed the servicers for LPI premiums in 2012

According to the Enterprises, they reimbursed their servicers $360 million for LPI-related premiums in 2012.

Step 2: Estimate the Enterprises' actual LPI proceeds in 2012, i.e., the payments the Enterprises received as a result of claims submitted for their LPI-related losses

Data regarding the amount of proceeds the Enterprises received from their servicers for LPI-related claims was not readily available. Accordingly, we could not precisely calculate their actual loss ratio. Therefore, we used the 2012 nationwide average loss ratio for LPI providers, which we derived from data compiled by the National Association of Insurance

Commissioners (NAIC).[50] This figure—30.8%—served as a proxy for the Enterprises' actual LPI-related loss ratio in 2012.[51]

We estimated that the Enterprises received $111 million in LPI proceeds in 2012, as depicted in Figure 5 below.

FIGURE 5. ESTIMATE OF THE AMOUNT OF LPI PROCEEDS THE ENTERPRISES RECEIVED IN 2012

$$\text{Loss Ratio} = \frac{\text{Insurance Proceeds}}{\text{Premiums}} \quad \dashrightarrow \quad 30.8\% = \frac{X}{\$360\text{ million}} \quad \dashrightarrow \quad X = \$111\text{ million}$$

<u>**Step 3**</u>: Estimate how much the Enterprises should have reasonably paid for receiving $111 million in LPI proceeds

Next, as depicted in Figure 6, below, we estimated how much the Enterprises should have reasonably paid for LPI coverage under the assumption that they received $111 million in insurance proceeds from LPI providers in 2012. To do so, we used a 55% loss ratio, which was the expected LPI loss ratio QBE's subsidiary had on file with the state of New York prior to the NYDFS investigation.

FIGURE 6. ESTIMATE OF WHAT THE ENTERPRISES' 2012 LPI PREMIUM REIMBURSEMENTS WOULD HAVE BEEN ASSUMING LPI RATES WERE PRICED TO MAINTAIN A LOSS RATIO OF 55%

$$\text{Loss Ratio} = \frac{\text{Insurance Proceeds}}{\text{Premiums}} \quad \dashrightarrow \quad 55\% = \frac{\$111\text{ million}}{Y} \quad \dashrightarrow \quad Y = \$202\text{ million}$$

<u>**Step 4**</u>: Calculate the estimated financial harm to the Enterprises

As depicted in Figure 7, below, we estimate that if LPI providers set their rates to produce a 55% loss ratio in 2012, then the Enterprises would have reimbursed their servicers $202 million for LPI premiums—$158 million less than they actually paid in 2012.

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[50] NAIC is a voluntary association of the heads of insurance departments from each state, the District of Columbia, and five U.S. territories. NAIC provides a national forum for addressing and resolving major insurance issues and for promoting the development of consistent policies among the states. The NAIC requires LPI providers to submit their previous years' credit insurance experience data on collateralized real property. NAIC does not endorse any analysis or conclusions based upon the use of its data.

[51] 30.8% represents the ratio of LPI providers' incurred claims to earned premiums in 2012.

FIGURE 7. ESTIMATE OF ENTERPRISES' FINANCIAL HARM DUE TO EXCESSIVE LPI RATES IN 2012

Enterprise Reimbursements for LPI Premiums	Estimate of Reasonable Price for Equivalent LPI Coverage	Estimate of Financial Harm
$360 million	$202 million	$158 million

Methodological Limitations

The methodology described above is subject to the following limitations:

- Our estimate assumes that the Enterprises' actual 2012 LPI loss ratio is similar to the nationwide average LPI loss ratio of 30.8%, which we computed using data compiled by the NAIC.[52] Nevertheless, we believe that the 30.8% figure is conservative in that it is higher than the average nationwide LPI actual loss ratio from 2004 to 2012—25.3%. Further, internal documents from one of the Enterprises indicate that its estimated historical LPI loss ratio was substantially less than 30.8%.
- Our utilization of 55% as a reasonable loss ratio is based upon one state insurance regulator's investigation. Specifically, we examined NYDFS' consent orders with subsidiaries of both Assurant and QBE.[53] We chose to use QBE's expected loss ratio of 55% rather than Assurant's expected loss ratio of 58.1% because it was a more conservative estimate. Our estimate is also conservative in that a condition of both consent orders with Assurant's and QBE's subsidiaries requires them to file new LPI rates that produce a minimum expected loss ratio of 62%.[54] Additionally, NYDFS has recently proposed implementing a new regulation requiring all LPI providers in the state to refile their LPI rates so that they produce a minimum expected loss ratio of 62%.[55]

[52] LPI providers submit their actual loss ratio data to the NAIC by submitting Part 4 of the Credit Insurance Experience Exhibit. We used that data to compute the 2012 nationwide LPI provider loss ratio.

Part 4 of the NAIC's Credit Insurance Experience Exhibit does not distinguish between lender-placed hazard insurance and lender-placed flood insurance. Lender-placed hazard insurance, however, accounts for the vast majority of the data. Moreover, the two product lines are sufficiently similar to warrant generalizations, according to industry experts.

Additionally, through 2012, QBE had not submitted Part 4 of the Credit Insurance Experience Exhibit; rather, it submitted Part 5, which is titled "Other Credit Insurance." In calculating our loss ratios we assumed that QBE's data on Part 5 of the Credit Insurance Experience Exhibit refers to its LPI portfolio.

[53] Such granular loss ratio data were not readily publicly available from regulators in Florida and California.

[54] NYDFS Consent Order with Assurant, at 8; NYDFS Consent Order with QBE, at 9.

[55] 11 NYCRR § 227.7 (Proposed). The proposed regulation was released for public comment in the State Register on September 25, 2013. As of February 19, 2014, NYDFS was still considering public comments on the proposed regulation.

- Either Enterprise may request that a lender repurchase a loan if it finds a defect in the loan's underwriting quality. If the loan has already been liquidated, then the Enterprise can request that the lender remit a "make-whole" payment. Theoretically, this payment would compensate the Enterprise for any LPI-related cost associated with the loan. Our estimations do not include any compensation the Enterprises may have received due to repurchase requests.

This study was conducted under the authority of the Inspector General Act and is in accordance with the Quality Standards for Inspection and Evaluation (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency. These standards require us to plan and perform an evaluation based upon evidence sufficient to provide reasonable bases to support its findings and recommendations. We believe that the findings and recommendation discussed in this report meet these standards.

The performance period for this evaluation was October 2013 to January 2014.

APPENDIX A ....

FHFA's Comments on FHFA-OIG's Findings and Recommendation

Federal Housing Finance Agency

MEMORANDUM

TO: Richard Parker, Deputy Inspector General for Evaluations

FROM: Alfred Pollard, General Counsel

SUBJECT: Evaluation Report: *FHFA's Oversight of the Enterprises' Lender-Placed Insurance Costs,* SUR-2013-017

DATE: June 18, 2014

This memorandum transmits the Federal Housing Finance Agency's (FHFA) management response to the recommendation resulting from the evaluation report on *FHFA's Oversight of the Enterprises' Lender-Placed Insurance Costs* (SUR-2013-017) performed by your staff from October 2013 to June 2014. As stated in the report, the purpose of the evaluation was to assess the financial impact of LPI on the Enterprises and to determine whether FHFA, in its role as the Enterprises' conservator, has taken sufficient measures to conserve the Enterprises' assets in this regard.

This memorandum identifies the actions that FHFA will take to address the recommendation.

Recommendation

We recommend that FHFA assess the merits of litigation by the Enterprises against their servicers and LPI providers to remedy potential damages caused by past abuses in the LPI market and, then, take appropriate action in this regard.

Management Response

The Federal Housing Finance Agency has reviewed the recommendation in this Evaluation Report and does not object. Pursuant to FHFA's independent litigation authority, the FHFA Office of General Counsel (OGC) will complete an assessment of whether or not to institute any legal action against servicers or LPI providers within the next twelve months.

FHFA OGC reviewed all elements of the Report with OIG staff and provided input. Of note, the methodology employed by the OIG in its review would not align with the approach that OGC would undertake in a litigation assessment. Such assessments routinely involve an analysis of the parties involved, available information, legal arguments and litigation risks, economic assessments and consideration of relevant public policies. OGC does not comment publicly on its litigation analyses or plans.

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